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FEDERAL COMMUNICATIONS COMMISSION
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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, DC 20554

In the Matter of)
)
Price Cap Performance Review)
for Local Exchange Carriers)

CC Docket No. 94-1

REPLY COMMENTS OF
CITIZENS FOR A SOUND ECONOMY FOUNDATION

Citizens for a Sound Economy Foundation (CSE Foundation) would like to address several issues raised by other commenters in the Commission's fourth year review of the Local Exchange Carrier (LEC) price cap plan. They include LEC profits, flexibility of pricing, and competitive concerns.

LEC PROFITS

Adjusting the productivity factor

Other participants in this proceeding have recommended adjustments to the productivity factor that generally reflect their immediate financial interests. AT&T and MCI, for example, argue that the LECs have achieved greater than expected productivity gains, and so the productivity adjustment should be raised to more than 5 percent.[1] Several LECs, on the other hand, argue that new estimates of their true long-run total factor productivity are lower than the Commission anticipated, and so the Commission should lower or eliminate the productivity

[1] See Comments of AT&T, in this proceeding, p. 22, and Comments of MCI Telecommunications Corporation, p. 18.

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offset.[2]

Both sides present analysis and studies to support their recommendations, and both make some seemingly reasonable arguments. CSE Foundation agrees with the LECs that it is reasonable to use long-run total factor productivity as the relevant standard -- as long as we can expect future productivity trends to be a continuation of the past. CSE Foundation also agrees with AT&T and MCI that more recent productivity performance should be taken into account -- if the LECs' most recent productivity performance is a better predictor of the future than their historical performance. The problem, of course, is that we do not know which past data better predict future performance, because the future has not happened yet.

Given the evidence submitted, we are not convinced that LEC productivity has made a radical break with past trends; this result suggests that the productivity factor should not be raised. At the same time, the LECs seem to have earned adequate revenues under price caps to ensure their financial viability, and so we are not convinced that the productivity factor should be lowered either.

More importantly, CSE Foundation would like to point out another dimension of the productivity factor debate that has received scant attention up to now. Most parties to this proceeding have focused only on the benefits of altering the productivity factor, without regard to the cost. But the benefits are not costless. The purpose of price cap regulation is to sever the link between the regulated firm's rate of return and its accounting costs, so that the firm can earn a higher rate of return by enhancing efficiency. If LECs know that high earnings will be

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[2]Comments of Bell Atlantic, pp. 13-17; GTE's Comments, p. 73; Comments of Pacific Bell and Nevada Bell, pp. 33-34.

followed by an increase in the productivity factor, they will invest only in those innovations that pay off before the next review of the price cap plan. In short, price cap regulation will degenerate into rate of return regulation with regulatory lag.

A lower productivity factor, on the other hand, could conceivably generate greater efficiency and consumer savings, because the reward for such efficiency would be increased. However, a decrease in the productivity factor could also compromise the integrity of price cap regulation. If the Commission lowers the productivity factor now, it could just as easily raise it later. Lowering the productivity factor would give the LECs greater profits for a few years, but it would also increase the uncertainty of returns after the next regulatory review. This uncertainty could counteract any near-term benefits by raising the LECs' cost of capital as the next review approaches.

CSE Foundation is also concerned about another cost that could result from a change in the productivity factor. A change in the productivity factor would encourage participants in this proceeding to expend greater resources convincing the Commission to make another change in future proceedings. Such expenditures may benefit some of the parties in this proceeding, but from a consumer perspective, they represent pure waste.[3] The resources expended in arguing about the productivity factor could be better spent on development of new products and services that actually meet human needs. By maintaining the current productivity factor, the Commission can encourage telecommunications firms to devote their resources to productive endeavors, instead of jockeying for advantage in regulatory proceedings.

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[3] See J. Buchanan, G. Tullock, and R. Tollison, Toward a Theory of the Rent-Seeking Society (1980).

Adjusting depreciation schedules

Several LECs have raised a relevant and related issue in their discussion of depreciation schedules. They argue that a Commission-mandated, three-year depreciation schedule is unrealistic, because many assets lose their economic value more quickly than that.[4] Pacific Bell, for example, demonstrated that its 1991-93 rate of return is about 25 percent lower when calculated using the more realistic depreciation schedules that the Commission permits AT&T to use.[5]

It might seem that longer depreciation schedules enhance consumer welfare, because longer writeoff periods diminish the prices that consumers pay for telecommunications services. Such an assumption takes a very shortsighted view of consumer welfare. Consumers as a whole are best off when the prices they pay reflect the actual economic costs associated with their use of a product or service. If regulation depresses prices below economic costs, it makes consumers worse off in the long run, because firms cannot earn sufficient returns to improve or replace their assets. Consequently, we agree that the Commission should permit the LECs to employ depreciation schedules that reflect assets' true loss of economic value over time.

FLEXIBLE PRICING

Participants have raised concerns about the LECs' ability to alter prices of different services within various price cap baskets. Especially noteworthy are fears of predatory pricing and price discrimination. CSE Foundation believes that such fears are grossly overstated.

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[4]Comments of Bell Atlantic, pp. 9-10; Comments of Pacific Bell and Nevada Bell, p. 31.

[5]Comments of Pacific Bell and Nevada Bell, p. 31.

Indeed, one of the great virtues of price cap regulation is that it eliminates the incentive for these types of behavior.

__Predatory pricing__

A steady stream of scholarly literature questions whether genuine predatory pricing is ever a viable business strategy.[6] A firm engaging in predatory pricing must cut prices below marginal cost, shoulder losses until its competitors leave the industry, and then prevent the entry of new competitors. Nevertheless, a report submitted by the Association for Local Telecommunications Services raises the specter of predatory pricing, arguing that newer economic literature on "strategic behavior" has refuted earlier arguments suggesting that predatory pricing is unlikely. Essentially, the strategic behavior literature suggests that a firm can engage in profitable predatory pricing by cutting prices deeply in only a few markets. This action creates a credible threat that the firm will do the same in other markets, thus effectively deterring entry in those markets.[7]

Unfortunately for those who fear predatory pricing, such theories quickly unravel. A firm that employs predatory pricing in one market must somehow demonstrate that it is willing

[6]J. McGee, "Predatory Price Cutting: the Standard Oil of New Jersey Case," J. of Law & Econ 23 (Oct. 1958), pp. 137-69; McGee, "Predatory Pricing Revisited," 23 J. of Law & Econ. 289 (1980); K. Elzinga, "Predatory Pricing: The Case of the Gunpowder Trust," 13 J. of Law & Econ. 223 (1970); R. Koller, "The Myth of Predatory Pricing--An Empirical Study," 4 Antitrust Law & Econ. Rev. 105 (1971); W. Brock and D. Evans, "Predation: A Critique of the Government's Case in US v. AT&T," in Evans and Brock, Breaking Up Bell (1983).

[7]J.B. Duvall and J.G. Williams, "Guidelines for Designing Federal Regulatory Policy to Promote Competitive local Telecommunications Services" (report prepared for Association for Local Telecommunications Services), May 1994, p. 20.

to do so in all markets. Competitors know that predatory pricing in all markets is not a profitable strategy, and so they know that the predator will not cut prices in all markets. Thus, the predatory threat is not very credible. And even if it were, the competitors can turn to customers for assistance. Sensible customers should be willing to sign long-term contracts with competitors offering reasonable prices, if they genuinely believe that a dominant LEC would otherwise drive the competitors out of business. Judge Frank Easterbrook of the U.S. Court of Appeals for the Seventh Circuit has made precisely this point. After surveying numerous studies showing the paucity of evidence in actual predatory pricing cases, Easterbrook concluded, "The antitrust offense of predation should be forgotten."[8]

Given these realities, it is no surprise that the United States Supreme Court has declared,

> The success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain...For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried and even more rarely successful.[9]

CSE Foundation agrees. The theory of predatory pricing provides no justification for limiting LEC pricing flexibility.

Price discrimination

One participant, Wiltel, offers a radical prescription to prevent unreasonable price discrimination when LECs introduce new services: force LECs to allocate overhead expenses

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[8]F. Easterbrook, "Predatory Strategies and Counterstrategies," 48 Univ. of Chicago Law Rev. 263 (1981).

[9]Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 US 574 (1986).

uniformly across all services.[10] CSE Foundation urges the Commission to reject this approach as inimical to consumer welfare.

It is a truism among regulatory economists that in the presence of economies of scale, uniform overhead allocation often diminishes consumer welfare.[11] To see why, consider an LEC that offers two services, one with a high elasticity of demand and one with a low elasticity of demand. If the LEC allocates overhead expenses uniformly across these two services, the customers who are very responsive to price (high elasticity of demand) will reduce their purchases significantly. The customers who are not very sensitive to price (low elasticity of demand) will reduce their purchases by only a small amount. Now consider what happens if the LEC allocates a larger portion of the overhead to the customers who are not very price-sensitive. They will pay higher prices, but most will continue to buy. But by getting this group to cover more of the overhead, the LEC can now cut prices to the price-sensitive customers. Faced with a lower price, this group buys a great deal more of the service. For decades, economists have agreed that the gains to the price-sensitive customers under this arrangement outweigh the losses to the customers who are not sensitive to price.[12] Thus, the LEC enhances overall consumer welfare when it allocates more of the overhead expenses non-uniformly.

Uniform overhead allocation is also an unsound business practice. If the incremental cost of a service is $10 and consumers are willing to pay $11, it is profitable to sell the service. The customers make at least some contribution to overhead costs, and the firm is better off with this

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[10]Comments of WilTel, Inc.

[11]D. Spulber, Regulation and Markets (1989) at 159.

[12]W. J. Baumol and D. F. Bradford, "Optimal Departures from Marginal Cost Pricing," 60 Amer. Econ. Rev. 265 (1970).

contribution than without it.[13] Suppose now that if the firm allocated overhead costs uniformly across services, the fully-distributed "cost" of this service would be $12. The firm would decline to sell the service, and it would lose the $1 contribution to overhead costs that this service would generate. As a result, the firm would have to raise prices on other services to fully cover its overhead costs.

Across the United States, economics and MBA programs teach tens of thousands of students each year about the folly of uniform overhead allocations. It would be unfortunate if the Commission were to force this folly on the LECs.

COMPETITION

Defining competition

CSE Foundation has already presented our perspective on defining competition.[14] However, we take especially strong exception to the argument that local loop service will always be a monopoly because each consumer will only have one telephone company at any time.[15] There are two problems with this argument.

First, it is conceivable that some customers will subscribe to multiple local loops simultaneously. A homeowner, for example, need not rely on the same company for a landline phone in the kitchen and a cellular phone in the car.

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[13]T. Nagle, The Strategy and Tactics of Pricing (1987) at 14-57; R. Cooper and D. Kaplan, "Profit Priorities from Activity-Based Costing," Harv. Bus. Rev. 91 (May-June 1991) at 130.

[14]Comments of Citizens for a Sound Economy Foundation, pp. 9-13.

[15]Comments of WilTel, Inc., pp. 36-37.

Second, even if many people subscribe to only one phone company, competition should operate to keep rates in check and terms of service reasonable. On any given day, a LEC may technically have a monopoly on some people's local phone calls. But if other competitors are in the market or willing to enter, the LEC knows that customers can switch. Thus, consumers' ability to switch phone companies should keep rates in check.

Customers' ability to switch should also keep LECs from unilaterally dictating other terms of service. WilTel seems to fear that LECs will forever discriminate against telecommunications firms who do not have their own local loops. But to the extent that this practice harms customers, customers have an incentive to choose LECs offering open access. (Of course, there will be a role for regulators here to ensure that carriers claiming to offer open access actually do so, but regulators will be enforcing a contract rather than forcing a particular type of contract on the customers.)

For many customers, the promise of open access may even be a stronger selling point than price. Other customers might be willing to forgo open access and take the risk of paying higher prices, because they find it more convenient to deal with only one company for all of their telecommunications services. A competitive market enhances consumer welfare by allowing both types of customers to make the choices that best meet their needs. In a world of competing LECs, as long as a substantial number of customers want open access, some competitor will find it profitable to offer open access -- even if there are no regulatory mandates.

CONCLUSION

CSE Foundation urges the Commission to resist "turning back the clock" to traditional public utility regulation. Genuine price caps, pricing flexibility, and LEC competition will best enhance consumer welfare.

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